

## **DON'T LET YOUR RETIREMENT CONTRIBUTION BE A TAXING EVENT!**

Tax-Sheltered Annuities (TSA) enjoy tax-favored treatment under section 403(b) of the Internal Revenue Code, which allows employees to save, on a tax-deferred basis, for their retirement. In order to maintain this tax-favored status, certain limits and requirements must be met. The Internal Revenue Service (IRS), through its audit efforts, has identified areas of concern and non-compliance in certain TSAs. Plan sponsors should review their operations and take steps to assure their plans are in compliance with the law and regulations. Generally, there are three types of failures: operational, demographic, and eligibility failures.

Examples of operational failures include the failure to satisfy the following requirements:

- The requirement that the right to make salary reduction contributions be made available to all eligible employees;
- The requirement that minimum required distributions be made to employees upon attainment of age 70 1/2;
- The requirement that employees be given the right to elect to directly roll over distributions into other retirement vehicles;
- The requirement that salary reduction contributions be limited to the annual elective deferral dollar limit (generally, \$10,500 for 2,000); and
- The requirement that contributions be limited to the cumulative limit on contributions (i.e., the maximum exclusion allowance (MEA)).
- The requirement that contributions be limited to the lesser of 25% of includible compensation or \$30,000 (annual contribution limitation)

Other failures include the failure to satisfy the nondiscrimination requirements (demographic failure), and the failure to be the type of employer that is eligible to maintain a TSA (eligibility failure).

### **Correction Programs**

The IRS has established three correction programs for sponsors of TSAs designed to preserve the tax benefits available for employers and employees and to promote the proper maintenance of TSAs. They are: the Administrative Policy Regarding Self-Correction (APRSC), Tax-Sheltered Annuity Voluntary Correction Program (TVC), and the Audit Closing Agreement Program (Audit CAP). For more information on the correction programs, see Revenue Procedure 2000-16, 2000-6 I.R.B. (January 21, 2000) which can be found on the internet at <http://ftp.fedworld.gov/pub/irs-irbs/irb00-06.pdf>.

### **APRSC**

APRSC empowers plan sponsors to correct operational failures without making a formal submission to the IRS and without paying a fee. If the requirements of the program are met, the IRS will not pursue income inclusion for affected participants, or liability for income tax withholding for plan sponsors. That is, the TSA will retain its status as a tax-favored retirement plan. Nevertheless, the correction of a failure may result in income tax consequences to participants. For example, participants may be required to include in gross income distributions

of excess amounts in the year of distribution. For a TSA plan sponsor to be eligible for APRSC, the plan sponsor or administrator of a plan must have established practices and procedures reasonably designed to promote and facilitate overall compliance with the requirements applicable to TSAs. These established practices and procedures must have been in place and routinely followed, but through an oversight or mistake in applying them, or because of an inadequacy of the procedures, an operational failure occurred. The practices and procedures may be at the plan sponsor, the vendor, or third party administrator level. Insignificant failures should be corrected within a reasonable amount of time after discovery. Significant failures generally must be corrected by the last day of the 2<sup>nd</sup> plan year following the plan year in which the failure occurred.

## **TVC Program**

The TVC program creates a way for plan sponsors to correct a wide variety of failures in their TSA plans with IRS approval. Most operational, demographic, and eligibility failures can be corrected under TVC. A fee structure has been created for the TVC program. Fees are based on the type of failure and the size of the plan.

## **Audit CAP for TSA Plans**

Under Audit CAP, if the IRS discovers operational, demographic, or eligibility failures while performing a plan audit, the plan sponsor may enter into a closing agreement rather than face adverse tax consequences. Since the failures are not voluntarily disclosed, the sanction imposed is a negotiated percentage of the amount of tax the IRS would collect if the failure were not corrected. The sanction will not be excessive and will be based on the plan sponsor equities and the nature, extent, and severity of the failure.

## **Correction Principles**

Whether using APRSC, TVC or Audit CAP, the plan sponsor must adhere to correction principles set forth in Revenue Procedure 2000-16. In general, these principles provide that the plan and employees be placed in the position they would have been in had the failure not occurred.

## **Frequently asked questions regarding TSAs**

**Q1.** I am a TSA plan sponsor and all I do is deduct salary deferrals from my employees' salaries and forward them to the annuity provider of their choice. Since I am not "administering" the plan, I don't have any further responsibility, do I?

**A1.** The plan sponsor is responsible for withholding the proper amount from employees' salaries for federal tax. If an employee exceeds the amount of contribution that can be properly deferred into the plan, the excess is income taxable to the employee. The plan sponsor could be subject of penalties for federal income tax withholding and FICA (if applicable) tax that should have been withheld on the excess contribution.

Q2. Our school system has a TSA for full-time teachers and Administrative Personnel. It is just too much administrative paperwork to extend coverage to part-time employees and substitute teachers. They wouldn't participate anyway, since they don't have a full-time salary. Do we have to cover part-time and substitute teachers in our salary deferral TSA?

A2. In order to meet nondiscrimination requirements of the law, once an plan sponsor permits any employee to elect a salary deferral into the TSA, the opportunity must be extended to all employees of the organization who may elect to have the plan sponsor make contributions of more than \$200 pursuant to a salary reduction agreement. Certain employees may be excluded. Employees who may be excluded include employees who are participants in an eligible deferred compensation plan (457 or 401(k)) or participants in another TSA, non-resident aliens, certain students, and employees who normally work less than 20 hours per week. Special care should be taken to comply with this requirement. Non-compliance could result in the entire TSA losing its tax-favored treatment.

Q3. Our school system has signed "hold harmless" agreements with our vendors. They have agreed to take the responsibility to assure the participant and plan sponsor contributions do not exceed any of the limits. Since we have this agreement, our school system doesn't have to worry about complying with the limits, does it?

A3. The "hold harmless" agreement is between the school system and its vendors. If the TSA has failures that result in additional federal withholding or FICA tax, the school system will be responsible for the proper amount of tax due.

Q4. I am a plan sponsor and I would like to be empowered to use the Administrative Policy Regarding Self Correction (APRSC) to correct Operational Failures that may be discovered in the future. What types of "practices and procedures" do I need to have in place in order to take advantage of the APRSC correction method?

A4. In order to use APRSC, a TSA plan sponsor must have established practices and procedures in place and routinely followed to facilitate compliance with the Internal Revenue Code, but through an oversight or a mistake in applying them or an inadequacy in the procedures, an operational failure occurred. The practices and procedures may be at the plan sponsor, vendor or third party administrator level. The determination about whether the plan sponsor has practices and procedures in place will be made based on the facts and circumstances in each case. Some examples of practices and procedures are (1) payroll procedures that identify contributions in excess of the salary deferral limit; (2) a procedure to review MEA calculations for participants; (3) a system to review part-time employees or substitute teachers to assure all eligible employees are given the opportunity to participate; and (4) a procedure to identify participants who are eligible for catch-up amounts in their salary deferral contributions. As noted above, the determination of the presence of practices and procedures is based upon the facts and circumstances in each case. The individual examples above may not necessarily result in a finding that practices and procedures exist. It should be noted that these practices and procedures must be reasonably designed to promote and facilitate overall compliance with the requirements for TSAs.

Q5. What are the most common compliance failures in TSAs that have been examined by IRS?

A5. The most common failures in TSAs are (1) Universal Availability – failure to offer a salary reduction option to eligible part-time employees and substitute teachers, (2) failure to comply with the Maximum Exclusion Allowance (MEA) limit, (3) failure to comply with the salary deferral limit and (4) failure to comply with the requirement that contributions be limited to the lesser of 25% of includible compensation or \$30,000.

Q6. I participate in a TSA and I have taken a loan from my account. I would like to repay my loan by including an extra amount in my salary deferral contribution to cover the loan payment. Can my loan payment be included as part of my salary deferral contribution?

A6. No. Your salary deferral contribution to the TSA is subject to distribution restrictions that limit distributions prior to death, disability, separation from service, financial hardship or attainment of age 59 ½. Using a part of the salary deferral contribution as a loan payment would result in an improper distribution and could have taxable consequences for the participant.

Q7. I know that the rollover rules for TSA rollovers were liberalized a few years ago. I am 35 years old and still working. I know of a really good investment opportunity and would like to roll a portion of my TSA into an Individual Retirement Account (IRA) so I can take advantage of this opportunity. Can I roll a portion of my TSA into an IRA so I can direct the investment?

A7. A rollover from a TSA to an IRA may be permitted if there has been a distributable event. A distributable event would include death, disability, separation of service, hardship or attainment of age 59 ½. Since you have not separated from service and are not age 59 ½, it does not appear that you have a distributable event. In such circumstances, a rollover from the TSA to an IRA would be an improper distribution and could have taxable consequences. A hardship distribution is not qualified for rollover treatment under any circumstances.

Q8. I know there is an annual 25% of compensation limit on employer and employee contributions to my TSA. My employer doesn't contribute to the TSA. All contributions are my salary deferral contributions. I make \$30,000 and I would like to make the maximum salary deferral contribution of \$10,500 to my account. Can I contribute the full \$10,500 since my employer doesn't make an employer or matching contribution?

A8. There are three contribution limits that apply to TSAs. In any given year, your contribution is limited to the least of these three limits. The three limits are: the maximum exclusion allowance (a cumulative contribution limit), the annual dollar limit on elective deferrals (generally 10,500 for the year 2000), and the annual contribution limit on employer and employee contributions (generally the lesser of 25% of compensation or \$30,000). Applying the annual contribution limit would limit your contribution to 25% of your compensation or \$7,500. Your contribution may be further limited by the maximum exclusion allowance. You may be eligible to make certain elections that may permit an increase in your contribution amount. See Publication 571 for additional information.

Q9. I am going to retire at the end of the current year. I did the catch-up computations under special catch-up rules for the year of separation from service contribution limit. I have not made a prior catch-up election. My figures indicate that I can put away \$30,000 in my final year. My contribution is all salary deferral with no employer discretionary or matching contribution. Can I make the election and defer the entire \$30,000?

A9. You are eligible to make the catch-up election because you have not made a prior “annual contribution limit” catch-up election. Once an election is made, it cannot be changed. Even though the catch-up election limit would permit a contribution of \$30,000, since your only contribution is a salary deferral contribution, you are still limited by the salary deferral limit of \$10,500. You must continue to apply the least of the three applicable limits, the annual contribution limit, the MEA limit or the salary deferral limit.

Q10. I work for the ABC public school system and I have 12 years of service with this employer. Prior to working for ABC, I worked for the adjoining county, XYZ public school system for 3 years. Since I now have 15 total years of service, I would like to take advantage of the increased salary deferral limit for long term employees. I know that in order to take advantage of the increased salary deferral contribution limit of 13,500, I must have 15 years of service. Since the two public school systems I have worked for are in the same state, can I add my years of service for ABC and XYZ public school systems to meet the years of service requirement?

A10. In order to take advantage of the salary deferral increased limitation; a participant must have 15 years of service with the employer for whom the limitation is being determined. For this purpose, separate school districts or systems are not treated as the same employer. Therefore, adding years of service for your two employers is not permitted. The annual dollar limit for salary deferrals, generally \$10,500 for the year 2000, would apply.

Q11. On retirement, I received a check for 20 years of accumulated sick leave pay. How much of that check can I use as includible compensation for my MEA calculation?

A11. Includible Compensation is generally defined as income earned in your most recent one-year period of service. Only a portion of the sick leave was earned in the most recent one-year period of service. The portion of the sick leave payment that may be used as includible compensation is that portion of the payment that was earned in the most recent one-year period of service.

Q12. My school system would like to learn more about compliance with the requirements of section 403(b) for Tax-sheltered Annuities. Does the Internal Revenue Service have any programs to help school systems comply with the law?

A12. The Internal Revenue Service currently has a program called the Section 403(b) Tax-Sheltered Annuity Partnership for Compliance. Under the Partnership for Compliance, trained and experienced IRS employees will be made available to provide educational services relating to section 403(b) tax-sheltered annuity arrangements including delivering speeches, participating in panel discussions, conducting training sessions and helping prepare newsletter articles.

Through these services, the IRS can provide information about the unique aspects of tax law applicable to tax-sheltered annuities and the problems that arise with them. For example, information can be provided on the impact to both the plan sponsor and the employee if excess contributions have been made, improper compensation had been included for calculating excludible amounts, or early distributions have been made to employees. Organizations interested in section 403(b) tax-sheltered annuities may request educational services under the Partnership for Compliance.